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MARKET DISCIPLINE IN THE ASIAN FINANCIAL CRISIS

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Abstract

The search for the real causes behind the Asia Financial crisis is turning up a lengthy list of suspects. In trying to comprehend the magnitude and contagion effects of the crisis, investors and policy makers from crisis-ridden countries have blamed the financial distress from speculative attack to the failure of free market capitalism. The purpose of this paper is to examine whether the free market capitalism or some other imminent factors should be blamed for the financial distress in Asia. Does the financial distress in the crisis advocates for tighter financial discipline among market participants or increase institutional and government control on both the creditors and borrowers?

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1. Introduction

The open, liberal economic regime, that dominated pre-crisis Asia, left countries in the region open to the ebb and flow of market forces. This attitude brought with it profound benefits, but also costs for macroeconomic policy makers and participants in the individual financial markets (Guitian, 1999). Until the Thai crisis in July 1997, these markets were growing both in size and importance; the region's countries could access “easy money” by opening up their capital markets and attracting the notice of the world investment community (Soros, 1998). Net international financial flows to developing countries tripled, from $50 billion a year in 1987-89 to more than $150 billion in 1995-97, before the Thai crisis. The gross figures showed a 1,200 percent rise between 1984-88 and 1989-94 (Eichengreen and Mussa, 1998). However, the mobility of free capital was constantly threatened by all kinds of speculative and arbitrageur activities.

In the wake of the Asian crisis, some critics challenged the rationality of such capital market liberalisation, but many failed to recognize that policy inconsistencies and institutional shortcomings in Asia were what stimulated an abrupt reversal in capital flows during the crisis and not liberation in the capital market. Particular among these were structural weaknesses in crisis-hit countries' banking supervisory systems and internal bank management systems. Having weak financial institutions not only has negative implications for domestic economic shocks, but could also intensify macroeconomic instability from external shocks (Letiche, 1998). This includes unwise policies, a growing current account deficit, excessive short-term foreign borrowing, the banking sector inundated with speculative property loans, corrupt bureaucratic and business practices (Schwartz, 1998). Thus, there is a strong feeling that transparency, appropriate disclosure, proper governance, and sound financial structures and standards are prerequisites for a well-functioning liberalized financial market (Guitian, 1999).

Faced with the task of implementing adequate response and safety features against the likelihood of future periods of financial instability, crisis-hit countries in this region seem to be either stagnant or paralyzed. In trying to comprehend the consequences of the Asian crisis and the volatility in the financial market, the list of suspected culprits is growing. Whilst the success of Asian economies took most of the blame, critics have shifted their argument to include the failure of free market capitalism, where financial market discipline is being eroded. They argued that what brought Asia to its grief was the deregulation of the domestic financial service industry, but this took place alongside imprudent and reckless bank lending, cronyism, and non-transparency real estate over-investment, which signaled a free flow of wealth and capital without any discipline. It is tempting (not to mention easy) to shift the blame to market forces. However, this runs the risk of ignoring the lessons that could be learned from the previous crises such as the Latin American crisis in overlooking the need to keep the banking system under a *strict discipline* (Harberger, 1985).

Many market oriented critics also blamed the crisis on moral hazard: the inclination of creditors and borrowers to accept excessive risk because of implicit guarantees of rescue should their businesses fail (Lachica, 1999). Many of these economies are dominated by conglomerates, non-transparent accounting practices, and close relationships between the corporate and financial sectors (Iskander, et al., 1999). The real estate boom in the region showed signs of collapse in 1995 (Letiche, 1998). There was excessive capacity in the real estate market. At the same time financial institutions and creditors were granting extravagant loans for speculation in real estate and equity assets without considering the potential of default. Thus, as borrowers went into default, banks' non-performing loans sky-rocketed.

The over 2-year old Asian Crisis has shaken global confidence in the financial markets. In trying to stabilize the global financial instability, the Prime Minister of Malaysia has been advocating a new international financial order that would monitor and manage speculative attacks on, and risks in, the global financial market from the free movement of capital and funds. The United States too is proposing a new lending accord within the IMF for stable and healthy economies facing speculative attacks against their currencies (Laird, 1999). At the recent APEC meeting held in Auckland, New Zealand, the 21-member economies firmly endorse calls to reform the rules governing global financial markets. Reflecting upon this level of governmental intervention, did free-market capitalism cause the grievances felt in the region's financial markets?

In essence, the objective of this paper is to examine the impact of free-market capitalism on the Asian crisis: free capital movement, Asian cronyism, property over capacity and consumers living beyond their means. The paper will examine whether free-market capitalism based on Adam Smith’s philosophy of *laissez-faire* should be blamed for the financial grief in Asia. Was the Asian Crisis an urgent and unmistakable call for tighter financial discipline or increase institutional and government controls on both creditors and borrowers?

2. What is Free Market Capitalism?

Adam Smith's *laissez-faire invisible hand* theory and David Ricardo's Law have been well documented in almost all economic systems, including the economies in transition from Communism to Market Economy and the mobility of capital funds. Both theories assume that free trade will increase economic wealth, efficiency, economies of scale and result in specialization. The corollary of which being that there is a reduction in barriers to mobility in capital markets. It is believed that allowing investments and lending the mobility to seek out rewarding opportunities would be economically efficient

According to Adam Smith's *laissez-faire invisible hand* theory the common interest is best served by allowing market participants to pursue their own self-interest with minimal (or no) state intervention. The theory believes that markets tend towards equilibrium. The behaviors of both demanders and suppliers are monitored via the price system. *However, such self-correcting equilibrium behavior is not applicable to the financial market due to market failure as they are, which is inherently unstable and risky*. Equilibrium applies to markets with known quantities: *financial markets deal with risk and uncertainty*. Financial markets deal with discounting the future, which is not only unpredictable but also indeterminate most of the time. Financial players are constantly attempting to predict the future which itself is conditioned upon the present decision. By contrast, equilibrium produces a determinate result.

Incentives matter to all participants in free market capitalism. Given their respective constraints, consumers maximize their utilities while producers maximize profit. In the financial markets, investors maximize their net worth given the risk. However, the incentive structure in the financial markets is complicated by asymmetry information panic, mania, speculation, and herd behavior (Hu, 1998). Where asymmetric information may lead to an unsustainable expansion of credit as a result of an incomplete evaluation of credit risks' implications, a small shake of confidence would lead to the subsequent panic withdrawal of funds away from the affected markets in droves

The World Trade Organization (formerly known as GATT - The General Agreement on Tariffs and Trade) preaches the laissez-faire, free market capitalism philosophy where every country should practice a fully liberalized economic system including the financial system, in which the state has only a minimal role. The WTO has succeeded in implementing successive tariff reduction in international trade over the decades since the formation of GATT in 1948 (Shutt, 1998). In spite of the agreement on an open liberal economic regime, the majority of governments still adopt some policies of selective intervention and subsidy in support of specific sectors or regions within their domestic economy.

During the Bretton Woods fixed exchange rate system (from 1945 to 1971), national governments were focusing on liberalizing their current accounts of their balance of payments to facilitate the free flow of trade in goods and services (Guitian, 1999). The increase in free trade activities subsequently led to a liberalization of cross-border financial and capital movements with a window of opportunities to profit. However, there was also an inherent danger that countries could misuse them in an undisciplined and costly manner. The recent grief caused by the Asian Crisis provides a good example of the inherent costs of an open, integrated, international capital market where market participants reacted in an undisciplined fashion. The complexities and riskiness of the capital market, and the severe punishment it imposes on imprudent behaviors suggest that the markets will continue to be volatile, that risk will not be completely removed, and that financial crises will continue to threaten in the future. This should come as a warning to market participants to behave in a disciplined manner and improve risk-management practices (Guitian, 1999).

3. Free Market Capitalism and the Asia Crisis

When the crisis under examination here first started in Thailand in July 1997, most people assumed that country was facing a liquidity crisis: the market reacted negatively to the financial service industry leading up to floating and devaluation of the baht. This shattered confidence among investors, both local and foreign. However, the prognosis has proven to be quite wrong and costly. Policymakers adopted measures and remedies to instill confidence in the economy, leading up to the shutdown of 56 troubled finance firms. Policymakers did not anticipate that the devaluation of the baht would turn into an “economic tsunami”, which subsequently cost Thailand billions of dollars (ultimately to be borne by taxpayers). They are the causes and effects of the crisis of solvency which remains unsolved (Janviroj, 1999). Thailand lenders and borrowers saw the pegged exchange rate as an implicit guarantee, with the consequence that they failed to consider and guard against the possibility of currency depreciation. They borrowed heavily from overseas without hedging against exchange rate risks, which could have insulated them from the destablising effects of unexpectedly large exchange rate movements.

Many Asian countries, and in particular East Asian economies, have opened up their financial markets in the past 10 years as a result of extraordinarily high growth. Credit was easily available and accessible with only limited regulations. However, the capital markets and financial systems did not keep pace with the extraordinarily high growth in the region: they were simply not ready for such growth. With growth came wealth and with wealth came greed, cronyism, structural weaknesses and mismanagement. East Asian economies mishandled the “easy money" that flowed into the region. This resulted in, among other things, the construction of apartment buildings which were subsequently left empty and unsold; the market became glutted with excessive numbers of real estate properties.

Much of the lending was based on a collateral basis, instead of on the basis of cash-flow, thus obscuring the need to analyze the profitability and riskiness of the investments. Credit tended to be made on the basis of personal or favored relationships, rather than on the basis of projected cash flows, recoverable collateral values and productive projects (World Bank, 1998). However, for reasons such as the implicit guarantees mentioned above, financial investors in the Asian Crisis invested heavily in the market without seriously considering risks' implications. For example, many failed banks in Thailand were overburdened with excessive loans and allowing asset prices to reach great heights while keeping the baht pegged to a rising U.S dollar (Lachica, 1999).

Undoubtedly, freer trade has undeniable costs, as does a liberalized but undisciplined financial market (Spaeth, 1998). A disciplined, liberalized financial market encouraged international financial transactions to hedge exposure to currency and commercial risk and the growth of derivative financial instruments such as options, swaps, and futures allowed investors to assume risks while limiting their exposure to others (Eichengreen and Mussa, 1999). However, many countries were busy removing restrictions on their capital account transactions in an attempt to capture the opportunities afforded by this remarkable financial market liberalization, without taking into consideration the fundamental principles of risk taking behavior. This greatly undermined the liberalized financial markets' mechanism efficiency for allocating financial resources, which was further complicated by the presence of information asymmetries.

The International Monetary Fund (IMF)-prescribed reform package was formulated based on the assumption that that the free flows of funds under a disciplined market system (i.e. one exhibiting "rational behavior") would lead to an efficient allocation of resources (Sulaiman, 1999). The market is further assumed to be self correcting (i.e. it will always tend towards a state of equilibrium) and the economy and the financial system would respond to shocks in a predictable manner. *However, these pre-conditions were not present*. What *was* blatantly apparent was that the financial markets during the period were extremely *unstable* and that self-correction towards equilibrium did *not* happen (Sulaiman, 1999; Sachs, 1998).

In essence, financial markets are vulnerable to risks and financial crises. There are established institutions such as the central banks and regulatory agencies to monitor the risks and financial crises from getting out of control. However, while central banks and regulatory agencies operate at the national level, financial markets have developed globally: the financial markets had the effect of a wrecking ball, knocking over one economy after another without warning as evidenced in the recent Asian crisis (Soros, 1999).

At the global level, the development of regulatory agencies has lagged behind the development of financial markets. The Bretton Wood Institutions, the IMF, the World Bank and the Asian Development Bank were designed each with different purposes in mind (Soros, 1999). This suggests that both private and public financial institutions should display greater discipline in confronting potential financial vulnerabilities and disruptions.

The removal of exchange controls and the end of quantitative restrictions on bank lending allows borrowers to borrow abroad with limitation placed on by domestic banks (Shutt, 1998). Domestic banks are supposed to limit their lending to a given ratio of their capital availability. However, in response to intensifying international competitive pressure, the liberalization of the capital markets and the growing sophistication of the financial markets, domestic banks began to engage in different areas of business with minimum supervision. This includes dealing in all kinds of financial assets and instruments such as options, futures and other derivatives and corporate mergers and takeovers, which had traditionally been performed by investment banks.

At the same time banks still enjoy the same implicit guarantees of state support in the event of threatened insolvency. Such imprudent activities only served to fuel the flames of moral hazard behavior generating excessive bad debts and non-performing loans, which was what inflicted severe financial damages on the Asian economy recently.

Free Market capitalism does not (and indeed cannot) address invisible barriers, like the close and special relationships between government and private sectors, borrowers and creditors taking excessive risks without full accountability. Such relations-based financial practices have been cultivated over the years and have long been accepted as a business norm and culture in the East Asian corporate world. Such practices appear where conglomerates are dominated by a small group of individuals; where there are non-transparent accounting practices; and where there is a 'special' relationship between the corporate and the financial sectors. For example, in 1997 the top 10 families in Indonesia controlled businesses worth more than half the country’s market capitalization; in South Korea, the majority of the loans are made to Chaebols (large corporate manufacturing conglomerates) (Iskander et al., 1999).

Before the Crisis, the majority of the debts owed to banks and corporation were short-term, 'un-hedged' and very volatile to interest rate changes - which constrains domestic monetary and exchange-rate polices. There were inherent structural weaknesses in the banks' regulatory and monitoring systems as well as internal bank management. Business profits were soaring at the expense of weak risk management practices while banks ignored the potential credit default, which ultimately resulted in many bank failures and bankruptcies. Inflow of capital was used mainly for speculative property instead of productively and this became the burden of high non-performing loans on domestic banks (Schwartz, 1998).

A key issue here is why risk-management models and internal control mechanisms, which are crucial in ensuring the stability of a liberalised financial market, failed to provide advance warnings of the Asia financial system’s vulnerability (Schinasi, 1999)? One possible answer to this is in the way a risk manager assesses risk: by separating market risk, credit risk and operational risk (i.e. in a fragmented fashion) instead of in an integrated one. Another reason is that most risk models assume that market liquidity will be sufficient to correct the errors without major price changes and market disruptions (Schinasi, 1999). When the Crisis struck, such risk assessment failed to adequately warn market participants who had not fully understood the severity of the risks.

Many 'risk' critics believe that market participants should have taken an overall view of these risks on an aggregate level to successfully manage them. Instead they engaged in imprudent excessive risk taking, excessive leveraging and ignored the interplay of the risk market forces (Schinasi, 1999). This indicates a lack of financial discipline in risk and portfolio management system of most financial institutions in Asia, which could not fend off unexpected external shocks. It is possible to predict therefore (albeit with hindsight) that some of the excessive risk-taking and leveraging *could have been avoided* if the financial regulators and institutions were structurally strong and disciplined.

There is also the question of whether the members of WTO would live up to their commitments of free trade. The financial elite - comprising of bankers, politicians and big business, all with vested interests in their positions - often precluded drastic rehabilitation measures. (Delhaise, 1999). For example, the introduction of bankruptcy laws in Thailand may lack the potency in overcoming the non-performing loan issues because of vested interests among various self-interest groups, which advocate for extensive restructuring and sound policies in credit allocation.

The increasing international competitive pressure on financial institutions and investors to find outlets for their funds in speculative assets, combined with the lax risk management in the financial markets had severe and damaging consequences in East Asia (Shutt, 1998). Undoubtedly the most notable of these were to the international fund managers and investments bank in Thailand, Indonesia, Malaysia and the Philippines that went on a lending binge from 1993 to 1996 (Sachs, 1997). Convinced that rapid growth would always bail them from bad lending, bankers and investors failed to ascertain the financial risks they would encounter. Asian bankers borrowed extensively from abroad mostly in short-term loans denominated in U.S dollars unhedged. By hedging they would have been able to reduce risk and creating certainty (Tracey, 1988).

Mushkat (1998) points out that the disorderly financial deregulation in the region resulted in an overly rapid expansion of credit, which was associated with “easy money” and low interest rates. Many Asian governmental policies act as a “safety net” that encouraged imprudent lending and excessive risk taking without accountability and disclosure practices. Furthermore, implicit government involvement in the private sector, and the lack of transparency in corporate and fiscal accounting, led to a sharp deterioration in the quality of banks' loan portfolio, making the crisis worse (IMF, 1999). Imperfect information and the lack of transparency hindered the provision of adequate financial risk assessment by market participants.

A more appropriate policy for national governments would be a rigorous prudential supervision and regulation of a financial system that depends less heavily on banks and other financial intermediaries for financial market participants to take on excessive risk. This includes on-site inspection, rigorous systems in classifying non-performing credits and closing failing financial institutions. This would help reduce the risks of costly financial crises and moral hazard behaviour while making market participants bear the full costs of their actions (Eichengren and Mussa, 1999).

Where asymmetry of information is present in the financial market, this gives rise to bad borrowers driving out good borrowers. For example, borrower A may service his debt regularly, and yet get no correspondingly favorable treatment from his bank; whilst borrower B, who refuses to pay, may ultimately get 'rewarded' for taking this line. Which is to say that, his banker may negotiate repayment with him, and in so doing offer him a better deal: lower interest rates and extension of loan repayments. In this scenario, there is no incentive for borrower A, who services his debt regularly, to continue as a model borrower. He may be tempted to turn delinquent (though the extent of his knowledge of Borrower B's situation would factor into this). Unfortunately however, just such an attitude is on the rise in Thailand (Yoon, 1999). Under such conditions, 'bad' debtors do not get 'black-listed' and get better offers through debt restructuring to boot! It is important to note here though that Thailand currently lacks both a credit bureau and bankruptcy laws to check up on delinquency among debtors.

4. Discipline in the Financial Market

Acting in a 'disciplined' fashion in financial markets implies that credit should be made to borrowers on the pretext of the borrowers' ability to repay and preventing them from abusing the system (Lane, 1993). However, where market discipline is relatively inefficient and weak, this allows borrowers to borrow beyond their ability to repay. An example of this is Thailand where the relationship-based lending and the lack of adequate bankruptcy laws had generated excessive non-performing loans causing massive bank failures. There is certainly an immediate need for strengthening financial discipline in the financial markets to monitor such abusive practices and drive out bad borrowers, while allowing good borrowers to benefit from their continuing access to credit. The legal system in the financial markets must be well designed and enforceable to ensure that borrowers do repay their debts (Lane, 1993).

The Asian Crisis stemmed from a series of inter-related causal factors: from domestic systematic weaknesses in the financial system to corporate governance and macroeconomic imbalances and policies, instead of market capitalism. Political and financial management have overlooked the importance of having sound financial institutions and corporate governance, including disclosure rules, therefore granting distorted incentives to financial and non-financial entities (Shirazi, 1998). At the corporate level, the political pressure to maintain high rates of economic growth led governments to ignore the importance of governance and transparency issues to assess risk in a liberalized financial world. This led to a tradition of public guarantees (implicitly and explicitly) to troubled firms and financial institutions. This in turn encouraged risky behavior by participants, with the belief that they will profit from the risky investments while being protected from the losses.

The first line of defense against risk in a liberalized financial market is sound risk management by market participants themselves (Eichengree and Mussa, 1999). Demirguc-Kunt and Detragachia (1998) show that banking crises are more likely to occur in liberalized financial systems that demonstrate a weak institutional environment coupled with corruption. Thus, the need is there for tighter financial discipline on the part of both borrowers and creditors. Financial institutions, including commercial banks, must practice prudent asset-liability management in managing their balance-sheet risks. Corporate borrowers must practice sound corporate governance in assuming risks. Excessive risk taking can be managed and contained through market discipline supported by transparency in accounting, auditing, and disclosure standards. Implicit governmental guarantees or bailout of weak financial institutions must be eliminated, so that lenders will be accountable if they fail to assess credit risk prudently (Eichengreen and Mussa, 1999). This will eliminate any distortions that interfere with the ability of banks and other financial institutions to manage and assess risks.

Rapid economic growth in a liberalized financial world without market discipline is not sustainable. Strong regulatory and legal infrastructures are needed for the financial system to be robust and withstand any macro shocks and economic distress. In designing an effective safety net for the financial system, the marketplace must be allowed to discipline financial risk-takers by allowing insolvent and troubled financial institutions to fail and by imposing severe penalties on institutions close to failing, thus increasing market discipline in the financial systems (Helfer, 1999). Further more, shareholders should lose their equity in a failed bank. This adds to the level of market discipline by under-mining the "too big too fail" philosophy. Over time, managers of financial institutions will be more cautious and pay more careful attention to risk taking during periods of economic distress, knowing that they may lose *their* jobs and any investments *they* have in their bank if it fails (Helfer, 1999).

Restructuring and improvement in corporate governance is essential in reducing excessive debt and risk taking. This involves a comprehensive and integrated approach linking corporate restructuring to bank restructuring in settling external debt problems (Iskander *et al*., 1999). Fundamental changes within the relationships between the government, corporate firms and banks are required. This should diminish "relation-based" finance practices while restoring confidence in the financial system with an effective new legal, regulatory, accounting, and institutional framework. In turn, this would lead to a competitive corporate and financial system that minimizes excessive risk taking in a disciplined fashion; it would install equitable risk sharing and responsibility among creditors, borrowers, and the government, enhancing market discipline in the financial markets (Iskander, et al., 1999). *Credit should be made on the principle of a borrower's ability to repay and not on some special relationship with the creditor.*

Good governance requires political commitment and competent agencies for implementing and enforcing a rigorous system of financial management and procurement, with prompt corrective actions and penalties in addressing malfeasance (Landell-Mills and Serageldin, 1991). This involves transparency and monitoring the performances of public agencies and private businesses dedicated to correct corporate governance abuses and inefficiencies.

Indeed, the efficiency of financial systems must be set within a disciplined legal and regulatory framework. Regional banks often lack adequate internal, market and regulatory discipline to deal with financial distress. A system of effective and reliable laws and regulations is required to stipulate the contractual rights and responsibilities of market participants so as to encourage discipline and prudent behavior in the financial market. Effective bankruptcy laws must be legally enforced to ensure that unviable firms do not continue to absorb credit. The presence of an effective bankruptcy system should help create a disciplined climate for monitoring risks taking between creditors and borrowers in the financial market.

5. Conclusion

The fact that free market capitalism is deficient in the financial markets does not mean that we should return to regulation, just as failure of Communism does not mean that markets are perfect. We have to acknowledge that all social arrangements from Market Economies to Communism is inherently imperfect. Perfectionism in the financial markets can never be achieved because of the asymmetry of information and because of uncertainty. Therefore we should seek the alternative best solution, namely a regulatory structure to ensure discipline in the financial markets.

The global financial market will continue to be volatile; risk will not be completely eliminated; crises will continue to occur. The best each participant can do is to improve risk management practices and limit severe economic fluctuation. The choice is between improved regulations at the global level or national regulations such those practiced by Malaysia. There is no way to completely avoid or isolate these market risks other than through disciplined behavior in the financial world. Country-specific policy actions must be designed - and be flexible enough - to guide and monitor the progress in this domain (Guitian, 1999).

It is clear that the greater a country's participation in financial liberalisation and its consequent exposure to the risks of foreign exchange markets, the more vulnerable it will be to the pressures of such risks. No government has more cause to be concerned of this than those associated with the recent fall of the Asian economies. There is an urgent need to re-examine the Asian model of development by highlighting the importance of a resilient, transparent, and well-regulated financial system as a prerequisite for full capital account liberalization (Mathieson *et al*., 1998). To survive in the liberalized financial markets, a country needs financial institutions which are able to protect the vulnerable segments of society and forge a durable consensus for global integration.

In a disciplined market fundamental cultural and institutional changes, with transparent relations between private corporations, government, and banks are pre-requisites to resolving corporate sector, financial sector, and external debt problems (Iskander et al., 1999). Corporate restructuring must be integrated with bank restructuring which, in turn, must be integrated with resolving external debt problems. There should be no artificial advantages existing in the financial markets in any form. The free mobility of capital flows across borders is regarded as an efficient way to allocate resources but this mobility also creates volatility and speculative opportunities that can potentially threatens a country's economic and financial system stability. Therefore, discipline by market participants is necessary in such volatile capital markets.

Whether we like it or not, free market capitalism is here to stay. The key to economic management of free market capitalism and integration with the rest of the world is vigorous structural reforms aimed at strengthening the financial system and the market forces at large. It would be a total mistake for any crisis-ridden country to withdraw from the system, closing down her capital markets, and retreating into financial isolation. National governments have to maintain their policies of openness and correct any structural imbalances in the financial and corporate sectors. The recent Asian crisis clearly showed that macroeconomic stability in a liberalized financial market, while necessary, is not sufficient for financial stability - something which also requires sound financial sector policies. This is critical to accompany financial liberalization in order to limit excess volatility and related problems and to contain any potential damaging effects (Eichengreen and Mussa, 1999). Thus, a disciplined liberalized financial market is more demanding in this respect. It includes a set of common prudenta and sound policies and frameworks, based on generally recognized practices, to ensure proper risk management, debt management and corporate governance (Guitian, 1999). A key challenge for national government is to ensure that market forces not only reap the benefits but also bear the costs of decisions, which generate negative consequences.

A few examples of financial discipline behavior in the market can be inferred from the Mexico (1994-95) and Thai (1997) crises (Klein, 1998; Schwartz, 1998; Lane, 1993):

i. Financial markets must be reasonably open, so that the borrower does not face a captive market;
ii. Credit should be made on the principle of the borrower's ability to repay, i.e. maintain prudent debt-servicing ratios so that repayment can be met even under worst-case circumstances;
iii. Information concerning the borrower's credit background must be available to prospective lenders to enable them to discriminate between bad and good borrowers;
iv. There should be no bailout in case the borrower cannot service its debts. Bailouts create moral hazard between lenders and borrowers releasing them from the consequences of their actions;
v. Financial institutions should not overburden the equity portion of capital financing with funds that can readily flee;
vi. A nation should not peg its currency to a larger creditor country currency that ties export price to a short-run fluctuations in the creditor country exchange rate. A currency peg to a basket of currencies (for example trade weights) provides better insulation against risk compared a peg to a single currency. A flexible exchange rate regime is much preferred.

Without a strong financial structure that includes transparent disclosure, good governance, strong capital adequacy standards and the mechanisms for enlisting help from the market in imposing discipline on system participants, any elements of financial safety net will be ineffective and costly in resolving a financial crisis such as the Asian crisis (Helfer, 1999). The challenge now is for the East Asian policy makers is to develop a strong and effective regulatory and supervisory framework for financial institutions with the likelihood of gaining credibility in the international financial markets. This also requires policy measures to restructure the corporate sector and untangle the solvent firms from the insolvent, and to stabilize and rehabitilate viable firms (World Bank, 1998). Banks and market participants should take a more precautionary financial leveraged approach in maximizing their wealth given the inherent global financial risks. The causes and cures for the Asian crisis are still debatable but there is still every reason to believe that free markets (with discipline) provide the best anecdote and climate for prosperity.

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